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In The

Supreme Court of the United States

October Term, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

On Writ Of Certiorari To The
Supreme Court Of Iowa

BRIEF FOR RESPONDENT

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QUESTIONS PRESENTED

1. Whether the Iowa Business Tax on Corporations, which adopts federal "taxable income" as the starting point for determining the apportionable "net income," thereby treating dividends from domestic and foreign subsidiaries differently, is constitutional under the Commerce Clause.

2. Whether Iowa's treatment of dividends for the Iowa Business Tax on Corporations is valid under the Equal Protection Clause because it is rationally related to legitimate state purposes.

3. Whether, if the Iowa tax law is held to be unconstitutional, the case should be remanded to the Iowa Supreme Court for determination of whether this Court's holding must be retroactively applied and whether refunds must be given.

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BRIEF FOR RESPONDENT

STATUTES INVOLVED

Set forth in the Appendix to this brief are relevant portions of the following statutes which are referred to in the brief but not already included in the Petition Appendix or the Appendix to Petitioner's brief: Iowa Code §§ 422.32(6) and 422.32(7) (1991), § 422.32(4) (1958), § 422.3(5) (1989); 26 U.S.C. §§ 882(a), 991, and 995(a) as in effect in 1981; 26 U.S.C. § 921(a) (1988), and 26 U.S.C. § 245(c)(1) (1988).

STATEMENT OF THE CASE

The Respondent, Iowa Department of Revenue and Finance (Department), accepts Petitioner's (Kraft's) statement of the case as substantially correct. The Department does *not*, however, accept the argumentative conclusions (at pages 7-8 of Kraft's brief) regarding the tax burden on, and discrimination against, a corporation which receives dividends from a foreign subsidiary. Also, the Department notes the following additional facts.

Iowa imposes an income tax on all corporations incorporated in Iowa and all corporations doing business in Iowa. Iowa Code § 422.33 (1991).[1] The tax is imposed upon corporate "net income" attributable to Iowa. "Net income" is defined as "the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue

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[1] References to the Iowa Code will be to the 1991 Code, unless otherwise indicated, since there is no material difference between those Code provisions and the provisions applicable to Kraft's 1981 tax year. The use of the term "foreign corporation" in § 422.33 should not be confused with the use of that term in the Internal Revenue Code and in the Stipulation. In § 422.33, a foreign corporation is any corporation organized under law other than Iowa law. *See* Iowa Code § 422.32(3). Also, the term "domestic corporation" in the Stipulation and Internal Revenue Code does not have the same meaning as it does in Iowa Code § 422.32(2) where it means any corporation organized under Iowa law. In this brief, "foreign corporation" and "domestic corporation" have the same meanings as in the Internal Revenue Code. A corporation incorporated in the United States is a domestic corporation, and a corporation organized in a foreign country is a foreign corporation.

Code," with certain adjustments, none of which mention foreign subsidiary dividends. Iowa Code § 422.35. (Stip. ¶ 14, Pet. App. 32a)

In imposing its income tax, Iowa divides the net income into two types. Iowa Code § 422.33(2)(a) provides for an allocation of "nonbusiness income," as defined in Iowa Code § 422.32(7). This type of income, which is not subject to formula apportionment, is not earned in the taxpayer's unitary business. Foreign subsidiary dividends which are nonbusiness income are wholly allocated to the corporation's commercial domicile. The other type of income is "business income," as defined in Iowa Code § 422.32(6). Business dividends are derived from the taxpayer's unitary business and are apportioned within and without Iowa under rules adopted by the Director of the Iowa Department of Revenue and Finance. Iowa Code § 422.33(2)(b)(1).

Dividends, whether declared by a domestic subsidiary or a foreign subsidiary, are declared and payable from the earnings of the subsidiary. (Pet. App. 41a)

Kraft concedes that the foreign subsidiary dividends which were paid to it constituted unitary business income and, under the Iowa Code, are included in Kraft's preapportioned net income base. (Stip. ¶ 20, Pet. App. 33a)

Domestic dividends that satisfy the various conditions imposed by the Internal Revenue Code (IRC) are deductible for federal income tax purposes. 26 U.S.C. §§ 243-246. Therefore, because "net income" in Iowa Code § 422.35 is based on federal taxable income, certain domestic dividends are deductible for Iowa income tax purposes.

Had Kraft's foreign subsidiaries been domestic corporations conducting their businesses exclusively in the foreign countries, the dividends that they declared to Kraft would, under authority of the Internal Revenue Code (IRC), have been deducted in determining Kraft's federal taxable income and, therefore, in determining "net income" for Iowa income tax purposes. (Stip. ¶ 21, Pet. App. 33a)

In 1981, the IRC permitted a domestic corporation that received nondeductible dividends from foreign corporations to claim a federal income tax credit for a portion of the income and certain other taxes paid by the dividend payors to foreign governments and for a portion of any foreign income taxes paid by the dividend payee with respect to the dividend. Alternatively, the dividend payee was allowed to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividends it received from foreign corporations. (Stip. ¶ 13, Pet. App. 31a)

Iowa does not allow a foreign tax credit. (Stip. ¶ 15, Pet. App. 32a) If, however, a taxpayer elected to deduct foreign taxes to determine federal taxable income, it would also deduct such taxes to calculate Iowa Code § 422.35 net income.

In the Polk County District Court, the only prongs of the Commerce Clause test argued by Kraft were the discrimination and multiple taxation prongs. (Pet. App. 11a-23a) Kraft abandoned the issue of an alleged unconstitutional interference by Iowa with United States foreign policy.

The District Court, in addition to what is noted in Kraft's Statement, found that Kraft had "not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa." (Pet. App. 17a)

In the Iowa Supreme Court, Kraft abandoned the multiple taxation question. The only Commerce Clause issue presented to the Iowa Supreme Court was whether the Iowa corporate income tax structure unconstitutionally discriminates against foreign commerce. (Pet. App. 5a) The Iowa Supreme Court held that there was no unconstitutional discrimination against foreign commerce because there was no showing "that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme." (Pet. App. 7a)[2]

SUMMARY OF ARGUMENT

Kraft could do business in foreign countries through domestically incorporated subsidiaries. Dividends from those subsidiaries would be deductible domestic dividends. (Stip. ¶ 21, Pet. App. 33a) Therefore, whatever different effect the Iowa tax law has on corporations operating through subsidiaries results solely from differences between the structures of their businesses, not from

[2] Even if the Iowa Supreme Court applied the wrong test in upholding the Iowa tax law, its decision must be affirmed if the law can be upheld on any grounds. *See Dandridge v. Williams*, 397 U.S. 471, 475 n.6 (1970) ("The prevailing party may, of course, assert in a reviewing court any ground in support of his judgment, whether or not that ground was relied upon or even considered by the trial court.").

the location of their commercial activities, and does not constitute discrimination against foreign commerce. *See Amerada Hess Corp. v. N.J. Taxation Div.*, 490 U.S. 66, 78 (1989). The Commerce Clause does not protect "the particular structures or methods of operation in a retail market." *Exxon Corp. v. Gov. of Md.*, 437 U.S. 117, 127 (1978).

If a corporation must operate in a foreign country through a subsidiary organized in that country, it can still easily avoid having its income from that subsidiary included in the Iowa apportionable income. A domestic holding company subsidiary, with no Iowa connection, could hold the stock of the foreign subsidiary, receive the foreign subsidiary dividends, and pass them on to the parent in the form of deductible domestic dividends. The parent could exclude those dividends from its Iowa net income base in the same way as dividends from earnings accrued from activities conducted wholly in the United States. The ease with which corporations can avoid having foreign dividends included in the Iowa tax base shows that the Iowa tax does not burden or discriminate against foreign commerce or violate equal protection.

Iowa adopted federal "taxable income" as the starting point in computing the Iowa apportionable "net income" in order to make the administration and enforcement of the tax manageable. There was no protectionist intent by the Iowa legislature. IRC provisions which apply to the determination of federal "taxable income" include ones which benefit foreign commerce or benefit doing business through foreign subsidiaries. Iowa adopts IRC provisions even when they favor out-of-state commerce or result in less tax revenue for Iowa.

Because of the way in which a corporation's unitary business is taxed, Iowa does not advantage either Iowa or United States activity at the expense of foreign activities. As a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income. A domestic subsidiary will pay federal income tax on all of its earnings, whereas only the portion of the earnings of a foreign subsidiary operating abroad which are returned to the parent in the form of dividends are subject to federal tax. The more business a corporation does in the United States, the greater its federal income tax liability will be. The Iowa tax law does not divert business from other countries to Iowa or to the United States.

The presumptively valid Iowa tax treatment of dividends is rationally related to legitimate state purposes, thereby satisfying the Equal Protection Clause. Iowa's conformity with federal taxable income determinations is not merely administratively convenient to taxpayers and Iowa, but is crucial for Iowa's ability to properly enforce its tax system. Iowa critically needs to rely upon the federal taxable income concept and Internal Revenue Service federal tax administration, including treatment of dividends.

These concerns with enforcement are not mitigated by Iowa's nine adjustments to federal taxable income. There is no constitutional requirement that a state conform wholly to federal taxable income determinations or to none of them. Moreover, the adjustments are few in comparison to the vast array of complex federal determinations that Iowa utilizes, and most of these adjustments can be verified from the taxpayer's federal return and in federal audits.

This Court should reject an amicus' suggestion that heightened scrutiny, rather than the traditional rational basis analysis proffered by Kraft, must be used to evaluate Kraft's equal protection challenge. Indeed, heightened scrutiny analysis, here, would be contrary to this Court's prior decisions.

ARGUMENT

I. THE IOWA BUSINESS TAX ON CORPORATIONS, WHICH ADOPTS FEDERAL "TAXABLE INCOME" AS THE STARTING POINT FOR DETERMINING THE APPORTIONABLE "NET INCOME," THEREBY TREATING DIVIDENDS FROM DOMESTIC AND FOREIGN SUBSIDIARIES DIFFERENTLY, IS CONSTITUTIONAL UNDER THE COMMERCE CLAUSE.

A state tax will be sustained "against Commerce Clause challenge when the tax is [1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). When the state tax is imposed upon foreign commerce, the test includes the four prongs in *Complete Auto* and, in addition, the considerations of "the enhanced risk of multiple taxation" and whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs. *Container Corporation v. Franchise Tax Board*, 463 U.S. 159, 185, 193 (1983); *see Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 448 (1979).

The Washington Legal Foundation (WLF), Kraft's amicus, argues (WLF br. at 11) that if the Iowa tax law is allowed to stand, the federal government is not capable of speaking with one voice on the subject of how foreign corporations will be treated in international commerce with this country. The consideration of whether the state tax "prevents the Federal Government from speaking with one voice" in foreign affairs is a prong of the Commerce Clause test separate from the discrimination prong. *Container*, 463 U.S. at 193; *Japan Line*, 441 U.S. at 448. Only the discrimination prong is at issue in this case. Kraft has waived all other prongs. (Pet. App. 5a; Kraft br. at 14).[3]

[3] "[A] state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." *Container*, 463 U.S. at 194. The Court noted in *Container* that the lack of an amicus curiae brief from the Executive Branch in opposition to the state tax was a factor suggesting that the foreign policy of the United States was not seriously threatened by California's taxing scheme. *Id.* at 195-96. In this case, the Executive Branch is filing an amicus curiae brief defending Iowa's tax scheme. Also, over the last fifteen years several bills have been introduced into Congress which would have limited the taxability of foreign dividends for state income tax purposes. *See* H.R. 2940, 100th Cong., 1st Sess. (1987); S. 1974, 99th Cong., 1st Sess. § 2 (1985); H.R. 3243, 98th Cong., 1st Sess. (1983); S. 1225, 98th Cong., 1st Sess. (1983); H.R. 2918, 98th Cong., 1st Sess. (1983); H.R. 1983, 97th Cong., 2d Sess. (1982); S. 655, 97th Cong., 1st Sess. (1981); S. 983, 96th Cong., 1st Sess. § 302 (1979); H.R. 5076, 96th Cong., 1st Sess. (1979); S. 2173, 95th Cong., 1st Sess. § 302 (1977); S. 1245, 93d Cong., 1st Sess. §§ 207 and 208 (1973). None of those bills were enacted. As in *Container*, 463 U.S. at 197, it cannot be concluded that the state tax at issue is preempted by federal law or fatally inconsistent with federal policy.

A. No Burden Is Placed On Foreign Commerce, Because The Difference In Treatment Of Dividends Is Not Based On The Type Or Location Of Commerce.

In analyzing a case under the Commerce Clause, "the State's interest, if legitimate, is weighed against the burden the state law would impose on interstate [or foreign] commerce." *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985).

The Iowa tax law does not put a burden on foreign commerce. Whatever different effect Iowa's treatment of dividends may have on those doing business in foreign countries through foreign subsidiaries and those doing business in foreign countries through domestic subsidiaries results from differences between the structure of their businesses, not from the location of their activities. The Commerce Clause does not, however, protect "the particular structures or methods of operation in a retail market." *Exxon Corp. v. Gov. of Md.*, 437 U.S. 117, 127 (1978). Kraft could do business in foreign countries through domestically incorporated subsidiaries. Dividends from those subsidiaries would be deductible domestic dividends. (Stip. ¶ 21, Pet. App. 33a)

Kraft and its amici constantly refer to "foreign source" dividends as being included in the Iowa tax base. That is an inaccurate characterization of those dividends which are included in the apportionable tax base. Dividends from a subsidiary incorporated in the United States could be "foreign source," in that they are paid from foreign earnings, but not be in the Iowa apportionable net income.

In *Amerada Hess Corp. v. N.J. Taxation Div.*, 490 U.S. 66 (1989), oil companies unsuccessfully claimed that the lack of a deduction for the windfall profits tax from "net income" for state income tax purposes violated the Commerce Clause by discriminating against interstate commerce. In responding to the claim that the provision discriminated against oil producers who market their oil in favor of independent retailers who do not produce oil, the Court stated:

> But whatever disadvantage this deduction denial might impose on integrated oil companies does not constitute discrimination against interstate commerce. Appellants operate both in New Jersey and outside New Jersey. Similarly, nonproducing retailers may operate both in New Jersey and outside the State. Whatever different effect the add-back provision may have on these two categories of companies *results solely from differences between the nature of their businesses, not from the location of their activities.*

490 U.S. at 78 (emphasis added). Whatever different effect the Iowa tax law has on corporations operating through unitary subsidiaries does not result from differences in the location of their commercial activities. A domestic subsidiary's commercial activities could be located in foreign countries.

In *Exxon v. Gov. of Md.*, 437 U.S. 117 (1978), "Exxon and other integrated companies could find no warrant in the Commerce Clause to operate in an integrated form within Maryland's retail gasoline market." Laurence H. Tribe, *American Constitutional Law* 25 (Supp. 1979). Similarly, Kraft and other multinational corporations can find

no warrant in the Commerce Clause to operate in foreign countries through foreign corporations rather than domestic corporations.

If a foreign country requires Kraft to do business there only through a company incorporated in that country, or Kraft for other reasons prefers to do business there through a foreign subsidiary, Kraft can still easily avoid having income attributable to its foreign operations included in its Iowa apportionable net income. Kraft could easily, as several multinational corporations have done, set up a domestic holding company to hold the stock of the foreign subsidiary. The holding company could have no function other than to hold the stock of the foreign subsidiaries, receive the foreign dividends and pass them on to its parent, Kraft, in the form of domestic dividends. Those dividends paid to Kraft by the domestic holding company would be deductible to the same extent as dividends from any other 100% owned domestic subsidiary. The holding company would not need to do any business in Iowa, and so would not be subject to the Iowa income tax. The holding company's income would not be included in the Iowa apportionable base, because Iowa has separate reporting, rather than combined reporting such as in *Container Corporation v. Franchise Tax Board*, 463 U.S. 159 (1983).

In *Regan v. Taxation With Representation*, 461 U.S. 540 (1983), the Court found that an IRC provision prohibiting substantial lobbying on the part of organizations qualifying to receive tax deductible contributions did not violate the First Amendment. The Court noted that the organization could set up a separate organization to do its lobbying. *Id.* at 544. The IRS required "only that the two groups

be separately incorporated and keep records adequate to show that tax-deductible contributions are not used to pay for lobbying." *Id.* at 544 n.6. That requirement was "not unduly burdensome." *Id.* Similarly, establishing a domestic holding company is not unduly burdensome.

The fact that corporations can so easily avoid having foreign dividends included in their apportionable income, without giving up their foreign operations, shows that the Iowa tax law does not burden or discriminate against foreign commerce. The Court has stated that discrimination "is a practical conception" and the Court "must deal in this matter, as in others, with substantial distinctions and real injuries." *Gregg Dyeing Co. v. Query*, 286 U.S. 472, 481 (1932).

B. Iowa Has Not Adopted The Internal Revenue Code Treatment Of Dividends In Order To Be Protectionist, But Because It Has A Substantial Legitimate Interest In Coupling With The IRC.

In 1955, Iowa Code section 422.35 was amended to couple the Iowa business tax on corporations to the Internal Revenue Code (IRC). The amendment defined "net income" to mean "the taxable income less the net operating loss deduction, both as computed for federal income tax purposes under the Internal Revenue Code of 1954, with the following adjustments:. . . . " 1955 Iowa Acts, ch. 208, § 19 (H.F. 225, 56th G.A.). The definition of "Internal Revenue Code of 1954" was routinely amended each year to include any amendments made to the IRC. *See, e.g.*, Iowa Code § 422.32(4) (1958). After the Tax Reform Act of

1986, Iowa Code § 422.35 referred to the "Internal Revenue Code," which means "the Internal Revenue Code of 1954, prior to the date of its redesignation as the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, or means the Internal Revenue Code of 1986 as amended . . . whichever is applicable." *See, e.g.*, Iowa Code § 422.3(5) (1989).

In order to find that Iowa treats foreign subsidiary dividends differently than domestic subsidiary dividends, one must look at the IRC provisions regarding dividends. This is not a case where foreign subsidiary dividends were singled out for a deduction denial. In *Amerada Hess v. N.J. Taxation Div.*, 490 U.S. 66, 77 (1989), the Court pointed out that the add-back provision at issue there "[did] not single out the windfall profit tax for a deduction denial" and that the Court did not need to consider whether a statute that did so would impermissibly discriminate against interstate commerce. Amendments to the IRC are adopted by the Iowa legislature regardless of whether they favor one type of commerce over another. The State accepts IRC exemptions and deductions, even when it means less tax will be paid to Iowa. There was no intent by the Iowa legislature to favor interstate commerce over foreign commerce or even to treat corporations differently based on the source of their dividend income.[4]

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[4] Considering all IRC provisions adopted by Iowa, it is possible that foreign commerce is favored over interstate commerce. "A great portion of the wealth owned by United States corporations is derived from business operations in foreign

(Continued on following page)

Iowa has not incorporated the IRC provisions into § 422.35 in order to be protectionist. It has adopted the federal "taxable income" concept in order to make the administration of the business tax manageable and to maximize taxpayer convenience and ease in complying with the Iowa tax laws. The Department can rely on IRS audits of taxpayers and judicial opinions interpreting the IRC. Using the federal taxable income figure allows the taxpayer "to merely lift the figures off the federal return and transfer them to the Iowa [income] tax return. The Department of Revenue receives the benefit of the regulations and interpretations of the federal agency." *First*

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countries." Jasper G. Taylor III, *The Foreign Tax Credit, Deferral, and the DISC Provisions: Casualties in a Holy War of Protectionism?*, 16 Houston L. Rev. 63, 63 (1978). One reason for the substantial foreign investment by United States corporations is the fact that the United States does not tax the earnings of United States shareholder-controlled foreign corporations until, with some exceptions, those earnings have been distributed to the United States shareholders. *Id.* This "deferral", as it is often called, allows the foreign corporation to reinvest all of its earnings if it so desires, thereby expanding its foreign operations. *Id.* at 63-64. "The tax benefits that arise from deferral are obvious. In some cases, deferral is tantamount to an exclusion from taxation, since foreign earnings are often never repatriated." *Id.* at 81.

There are several federal tax factors to be considered in choosing the form through which a foreign business venture is to be conducted. Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.10, at 17-29 (4th ed. 1979). "[I]t is ordinarily advantageous to a taxpayer whose business activities give rise to foreign-source income to have such business classified as a 'foreign' person. . . . " *Id.* at 17-28.

National Bank of Ottumwa v. Bair, 252 N.W.2d 723, 726 (Iowa 1977). The use of the federal taxable income figure avoids carrying out "complex procedures in computing the Iowa tax, involving the time and expense required to complete federal returns" by taxpayers. *Id.* The coupling of Iowa net income in § 422.35 with federal taxable income "is done for the convenience of the taxpayer, as a savings to the State, and to provide the State with a means of verifying the accuracy and honesty of a taxpayer's return." *Getty Oil Co. v. Taxation & Rev. Dept.*, 93 N.M. 589, 592, 603 P.2d 328, 331 (Ct. App. 1979).

The fact that the IRC allows a foreign tax credit does not mean that Iowa must also allow the credit. "The federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden that (sic) it would have to bear if its subsidiary's income were not taxed abroad." *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 191 n.30 (1983). There is no logical reason why a state would have to grant another credit of its own. *Id.* If Iowa followed the IRC with regard to the foreign tax credit, each dollar of foreign tax would result in a total of two dollars of credit in the United States. Also, the IRC credit provisions cannot be adopted without change. The federal credits, which apply to federal tax due on the total federal taxable income, could wipe out the Iowa tax liability. The foreign tax credit, for example, allows a credit for foreign taxes attributable to all of the foreign source income taxed by the IRC, not just for taxes attributable to the foreign subsidiary dividends apportioned to Iowa by Iowa's apportionment formula.

Kraft and its amici argue that it would be easy for the State of Iowa to add an adjustment to Iowa Code § 422.35

which would subtract from the federal "taxable income" figure the dividends from foreign subsidiaries. They fail to consider that by adopting federal "taxable income" as the starting point in computing the Iowa apportionable "net income," Iowa adopted all provisions of the IRC which apply to the determination of federal "taxable income," including IRC provisions which benefit only companies doing foreign commerce or only companies doing commerce through foreign subsidiaries.[5] If Iowa is required to decouple from IRC provisions giving domestic subsidiary dividends favorable treatment, it would presumably also have to decouple from IRC provisions

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[5] For example, in 1981, the year at issue, IRC provisions regarding Domestic International Sales Corporations (DISCs) were intended to "provide an inducement for increasing exports and . . . a means of removing discrimination against those who export through U.S. corporations." S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). A DISC allows large corporations to defer taxation on a portion of their export profits indefinitely. Phillip L. Jelsma, Note, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 Stan. L. Rev. 1327, 1332-33 (1986); *see* 26 U.S.C. §§ 991-997.

Amendments to the IRC effective for transactions after 1984 authorize the establishment of a system of foreign sales corporations (FSCs). A portion of the foreign trade income of a FSC is exempt from tax at the corporate level, provided it is derived from the foreign presence and economic activity of the FSC. *See* 26 U.S.C. §§ 921-927 (1988). The dividends paid by a FSC to a United States corporate shareholder from export income are tax-exempt at the corporate-shareholder level. 26 U.S.C. § 245(c) (1988); 47A C.J.S. *Internal Revenue* § 442(1), at 851 (1991). Although the FSC provisions were not in effect during the year at issue, 1981, they illustrate how IRC provisions may benefit only one type of commerce.

that benefit only foreign commerce or doing business through foreign subsidiaries. So many adjustments to federal "taxable income" could be required that the benefits of coupling with the IRC would no longer exist. Also, if states have to scrutinize all IRC provisions and future amendments to determine whether they favor one type of commerce over another, it will no longer be convenient for states to couple with the IRC. Decoupling from the federal tax system will be disadvantageous to taxpayers as well as to the states.

As discussed in the prior section of this brief, the Iowa tax law does not impose a burden on foreign commerce. As shown in this section of the argument, and discussed to a greater extent in Division II regarding the Equal Protection Clause, the State's interest in coupling with the IRC is legitimate and substantial. Therefore, the Iowa statute, § 422.35, does not violate the Commerce Clause. *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985) ("Under Commerce Clause analysis, the State's interest, if legitimate, is weighed against the burden the state law would impose on interstate commerce.").

C. Iowa Taxes The Total Unitary Business' Income In A Way Which Does Not Favor Any Local Iowa Activity Or United States Activity At The Expense Of Foreign Activities.

Because of the way in which a corporation's unitary business is taxed, Iowa does not encourage, protect, or otherwise advantage Iowa, *or United States*, activities at the expense of foreign activities. Indeed, the opposite is generally true.

Dividends payable to Kraft or any other parent corporation are paid from the subsidiary's earnings. (Pet. App. 41a) The unitary subsidiary, whether foreign or domestic, is merely an extension of the parent corporation's overall unitary business. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); (Pet. App. 30a, Stip. ¶ 10).

If the parent corporation subject to Iowa tax has a wholly owned unitary foreign subsidiary located solely in a foreign country, Iowa would include in apportionable net income only a portion of the subsidiary's earnings, as represented by dividends paid to the parent. Those dividends are less than the total earnings that would be taxed by Iowa if the subsidiary were a domestic subsidiary wholly located in Iowa. They are also less than the earnings of a wholly owned domestic subsidiary which are included in net income if the subsidiary does a portion of its business in Iowa. More earnings of the domestic subsidiary, which has income producing activities in Iowa, than earnings of the foreign subsidiary, which has no Iowa activities, are included in the preapportioned net income base for the unitary business as a whole.

If the wholly owned unitary domestic subsidiary does no business in Iowa, the dividends paid by it are not in the parent's preapportioned net income base, and its earnings are not taxed by Iowa. Yet, here again, Iowa activities are not encouraged, protected, or otherwise advantaged in comparison to out-of-state activities. The treatment of dividends does not encourage a parent to locate a subsidiary's activities in Iowa. The opposite is

true, because if either a domestic or foreign subsidiary were located in Iowa, Iowa's tax on the unitary earnings would likely increase. As a unitary business' Iowa activities increase, more of the unitary earnings will be included in Iowa net income, resulting in greater taxation of those earnings.[6] There is no direct commercial advantage to local Iowa business at the expense of non-Iowa business.

There is also no direct commercial advantage to United States business at the expense of foreign business. If the foreign subsidiary did business in the United States, it would be subject to federal income tax on the portion of its earnings effectively connected with the trade or business in the United States. 26 U.S.C. § 882(a); Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.04, at 17-22 (4th ed. 1979).

The example set forth at pages 14-15 of the WLF brief compares the treatment of dividends from a domestic corporation doing half of its business in Iowa with the treatment of dividends from a foreign corporation doing half of its business in Iowa and the other half in a foreign country. WLF fails to point out that the foreign subsidiary will pay federal income tax on only the portion of its earnings effectively connected with its business in Iowa, whereas the domestic subsidiary will pay federal tax on all of its earnings. Further, as discussed previously, the

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[6] The Commerce Clause "is not designed to protect local commerce." Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 926 (May 1986).

difference in the treatment of dividends is not based on whether foreign operations are conducted, but merely on where the subsidiary is organized.

The Iowa tax law does not favor domestic commerce over foreign commerce. Clearly, the more business that a corporation does in the United States, the greater its federal tax liability will be. Every corporation subject to the Iowa tax will be subject to the federal tax, and the amount of Iowa "net income" depends upon the amount of federal "taxable income."

There is no proof that a company operating in interstate commerce will have less of a tax burden than will a company whose unitary business includes doing business in foreign countries through foreign subsidiaries. If a unitary business confines itself to domestic operations, its unitary income stream could be subjected to greater tax than if it operates in foreign countries.[7] If every state adopted the Iowa method of taxation, the unitary earnings of domestic subsidiaries would be subject to state and United States taxation which could be more burdensome than the taxation of the foreign subsidiary earnings.

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[7] A domestic subsidiary's earnings are taxed by the United States Government and, if the subsidiary does business there, by the forty-six states and the District of Columbia which impose taxes on net incomes. Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 1.6, at 20-21 (1983). WLF's "simple question" (at p.7 of its brief), which supposedly demonstrates the "fundamental failure" of the Iowa tax, does not address a situation where the earnings from which domestic investment income is paid are taxed by the Federal Government and most states.

This possibility negates any claim that the Iowa tax system discourages investment abroad and protects that in the United States. It also counters the WLF's claim (WLF br. at 6) that the Iowa tax cannot pass the internal consistency test.

Because the Iowa treatment of dividends, within the context of its treatment of unitary earnings, does not favor Iowa or United States activities over those in foreign countries, the Iowa tax structure does not discriminate against foreign commerce in violation of the Commerce Clause.

D. The Iowa Tax Law Does Not Discriminate Against Foreign Products.

Kraft relies upon *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which invalidated a Florida law providing for an inspection fee for foreign cement but not for cement produced in the United States. In *Hale*, however, the Court emphasized that local Florida-produced cement was being protected from competition by foreign-produced cement. Also, in *Hale* the purpose of the statute was "to keep out foreign goods." *Id.* at 380. The Iowa statute at issue has neither the purpose nor the effect of favoring Iowa or other American products over foreign products.

The WLF argues that Iowa is effectively imposing a duty on the import of dividends from abroad. (WLF br. at 7-8) The WLF also discusses the Import-Export Clause of the Constitution.[8] (WLF br. at 12) The Import-Export

[8] U.S. Const. art. I, § 10, cl. 2.

Clause is not at issue in this case and should not be considered. Furthermore, the fact that a dividend could be paid in kind, such as in WLF's butter example, rather than in cash, does not change the dividend into a product being imported from abroad or change the tax on Kraft's Iowa income into an impost or duty.

> [I]ncome that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa.

Shell Oil Co. v. Iowa Department of Revenue, 488 U.S. 19, 30 (1988).

Cook v. Commonwealth of Pennsylvania, 97 U.S. 566 (1878), discussed by Kraft, does not support Kraft's argument. In *Cook*, a Pennsylvania tax was imposed on sales by auctioneers, with an exception for "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. The tax exemption favored American, including Pennsylvania, enterprises at the expense of foreign businesses. The Court stated that, by way of the Commerce Clause,

> the framers of the Constitution believed that they had sufficiently guarded against the dangers of any taxation by the States which would interfere with the freest interchange of commodities among the people of the different States, and by the people of the States with citizens and subjects of foreign governments.

Id. at 574. The Iowa treatment of dividends does not interfere with the free interchange of commodities among people of different states or by Americans with citizens and subjects of foreign governments. Dividends from subsidiaries are not treated differently based on whether the subsidiaries are selling American or foreign products, or based on where the products are being sold.

II. IOWA'S TREATMENT OF DIVIDENDS DOES NOT DENY PETITIONER EQUAL PROTECTION, BECAUSE IT IS RATIONALLY RELATED TO LEGITIMATE STATE PURPOSES.

Kraft and amicus Avon Products, Inc., et al. (Avon) make several equal protection attacks upon the Iowa tax treatment of dividends. First, Kraft and Avon erroneously urge that no legitimate purpose is served by Iowa's coupling of its net income base to the federal taxable income base which results in the dividend classification at issue. Second, Kraft concedes that such legitimate purpose may exist, but erroneously urges that Iowa's few federal conformity adjustments negate all benefits from conformity so that a legitimate purpose can no longer be found. Third, Avon erroneously urges that the Iowa tax treatment of dividends is subject to a heightened scrutiny.

Various fundamental principles apply in resolving constitutional challenges under the Equal Protection Clause. Where, as here, the challenged tax classification does not adversely affect a fundamental interest and is not based on a suspect criterion, it is tested under only the lenient standard of rationality that is traditionally

applied in evaluating equal protection challenges to regulation of economic and commercial matters. *Exxon Corporation v. Eagerton*, 462 U.S. 176, 195 (1983). Under this standard, a statute will be upheld if the legislature could have reasonably found "that the challenged classification would promote a legitimate state purpose." *Id.*; *see New Orleans v. Dukes*, 427 U.S. 297, 303 (1976); *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 547 (1983).

The broadest discretion is given to a legislature in creating tax classifications.[9] *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940).

> Traditionally classification has been a device for fitting tax programs to local needs and usages in order to achieve an equitable distribution of the tax burden. It has, because of this, been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification. Since the members of a legislature necessarily enjoy a familiarity with local conditions which this Court cannot have, the presumption of constitutionality can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes.

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[9] "Given the wide latitude of State legislatures in making tax classifications, comparatively few State taxes have been found repugnant to the Federal constitutional guaranty of equal protection of the laws." Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 3.3, at 43 (1983); *see* Paul J. Hartman, *Federal Limitations on State and Local Taxation* § 3:1, at 131 (1981).

Madden, 309 U.S. at 87-88 (footnotes omitted). The *Madden* Court's quoted statement has been consistently adopted by this Court. *Leathers v. Medlock*, 111 S.Ct. 1438, 1446 (1991); *Regan v. Taxation With Representation*, 461 U.S. 540, 547-48 (1983). In selecting subjects for taxation, a legislature "may make distinctions of degree having a rational basis," which "must be presumed to rest on that basis if there is any conceivable state of facts which would support it." *Carmichael v. Southern Coal & Coke Company*, 301 U.S. 495, 509 (1937).

A. Legitimate State Purposes Are Served.

The federal government has opted to include foreign subsidiary dividends in the domestic corporate parent's tax base and to provide a tax credit to alleviate dual taxation by the foreign and federal government. Whether Iowa's coupling of its tax base to federal taxable income[10] lacks a focus on avoiding double taxation is no basis to assert that such coupling does not serve legitimate state purposes. The Iowa Supreme Court properly noted the following legitimate tax policies served by that coupling:

> The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the

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[10] "The outstanding characteristic of State corporate net income measures is their broad conformity to the measure of the Federal corporation income tax." Hellerstein, *supra* note 9, ¶ 7.2, at 266.

> state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns.

465 N.W.2d at 669. (Pet. App. 10a)

Taxation of income of corporations involves massive and complex determinations and calculations of gross income and deductions, as a cursory reading of the IRC and Internal Revenue Service rules would suggest. Indeed, federal tax treatment of corporate distributions, including dividends, is "a wonderfully complex subject." Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.01, at 7-2 (4th ed. 1979). A host of complicated determinations with respect to dividends and corporate distributions exist. *Id.* at ch. 7. Moreover, the "treatment of foreign-source income is a complex subject." *Id.* ¶ 17.01, at 17-2. By coupling Iowa net income determinations with the federal taxable income concept, Iowa and taxpayers need apply only one set of rules that have been established on the federal level. Whether these rules arise from legislative, administrative, or litigated results, acrimony between taxpayers and tax agency as to the make-up of the tax base is significantly reduced, as are the attendant costs to both, because determinations made at the federal level will not be subject to decision anew or conflict with those at the state level.

It is critical to a state's ability to properly administer and enforce an income tax that it be allowed to use federal taxable income determinations. As one commentator noted:

> Even in those States whose laws contain no explicit provision for conformity in implementation, in the actual administration and judicial construction of the State statutes, the practice is

> ordinarily to follow the Federal rules and regulations and to adopt the results of the Federal audit with respect to the common terms incorporated by reference from the IRC, or as set out in the State's own detailed definitions that substantially follow the Federal terminology. Indeed, there is no other viable course, since State tax administrators have neither large enough staffs nor sufficient expertise to perform full-scale independent audits of the books and records of large corporations. Consequently, for all practical purposes, except in unusual circumstances, the State audit of corporate tax returns employing a net income measure begins with Line 28 of the taxpayer's Federal Form 1120, taxable income as determined by the IRS on audit.

Hellerstein, *supra* note 9, ¶ 7.2[5], at 275 (footnotes omitted).

It is clear that Iowa is justified in coupling its income tax base largely to federal taxable income. Otherwise, Iowa could not adequately administer and enforce the tax. Due to Iowa's inability to audit large corporations, taxpayers' initial decisions on determining and reporting corporate net income would, in practice, not be properly subject to review. This problem, more than any other, dictates that Iowa be allowed to conform to the federal taxable income base.

It is no answer to suggest that Iowa could cure the alleged discrimination by simply excluding foreign subsidiary dividends from the tax base. (Kraft br. at 29) First, that exclusion would require a state to expend its small resources on such issues as verifying, without the aid of

federal audits, whether distributions to large corporations were dividends or some other type of income that should be included in the income base. The Internal Revenue Service may be unconcerned with that distinction. Avon trivializes the administrative problems associated with decoupling from the IRC by arguing that the Department need only alter a tax form. (Avon br. at 18) Also, another issue could be verification of the amount of the dividends. The fact that some other states made political decisions to exclude all dividends from their income bases does not demonstrate that their tax administrators can easily administer such exclusions. Dividends are paid from earnings and profits. Computing earnings and profits "is often no simple task." Bittker & Eustice, *supra* ¶ 7.03, at 7-12. Iowa's small audit staff is not sufficient to make these determinations. Second, such a remedy suggests that the "cure" for any disputed income inclusion in a state tax base is merely one of exclusion. But, if that is the cure, the tax base could dissipate away. Third, this "cure" would effectively preclude Iowa from choosing to tax both foreign and domestic subsidiary dividends, an unreasonable result not mandated by the Constitution.

Kraft's argument that the dividend classification at issue violates equal protection even if effected because of difficulties otherwise inherent in the administration and enforcement of the tax cannot be squared with this Court's decision in *Madden v. Kentucky*, 309 U.S. 83 (1940). In *Madden*, the issue was "whether a state statute which imposes on its citizens an annual ad valorem tax on their deposits in banks outside of the state at the rate of fifty cents per hundred dollars and at the same time imposes on their deposits in banks located within the state a

similar ad valorem tax at the rate of ten cents per hundred dollars is obnoxious to the [Equal Protection Clause] of the Fourteenth Amendment." *Id.* at 86. The higher tax upon out-of-state bank deposits than upon in-state bank deposits, if imposed without justification, might have been stricken as "the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent." *See Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 878 (1985). However, the State had experienced difficulty in the administration and enforcement of the tax on out-of-state bank deposits, including a problem of concealment. In upholding the classification at issue, this Court noted that "treatment accorded the two kinds of deposits may have resulted from the differences in the difficulties and expenses of tax collection." *Madden*, 309 U.S. at 90.

If Iowa cannot rely upon the concept of federal taxable income and Internal Revenue Service enforcement of that concept, Iowa could conceivably be plagued by enforcement problems, including those due to concealment. If Iowa included domestic subsidiary dividends in the income base, concealment of such dividends would not be of import to the Internal Revenue Service since they are excluded on the federal level. In *Madden*, the state could have solved the problem of the out-of-state bank deposits by not placing them in the tax base, as Kraft and Avon suggest for foreign subsidiary dividends. This drastic measure was not required in *Madden*. It should not be required of Iowa.

Avon relies heavily upon *WHYY v. Glassboro*, 393 U.S. 117, 119 (1968), in which a property tax exemption that was denied to a nonprofit corporation solely on the basis

of the corporation's out-of-state incorporation was held to violate equal protection. (Avon br. at 17-19) While the classification was defended upon grounds of administrative burdens in evaluating a corporation's nonprofit status under other state law, this Court rejected that argument because other states' laws did not need to be considered. The opinion noted that there was no suggestion "that there is any greater administrative burden in evaluating a foreign [non-New Jersey] than a domestic corporation under New Jersey law." *Id.* at 120. This case has no analog to the problems posed if Iowa cannot rely upon federal determinations, including those associated with dividends.

Kraft argues that Iowa's treatment of dividends is similar to an attempt by Iowa to tax all Delaware corporations by apportioning their income as computed under Delaware law while other corporations' apportionable income would be computed under Iowa law. (Kraft br. at 27) Such an attempt by Iowa would not be related to federal taxable income and would be the very "invidious discrimination, the wholly arbitrary act" which violates equal protection guarantees. *New Orleans v. Dukes*, 427 U.S. 297, 303-04 (1976). The federal taxable income and Iowa taxable income concepts are based upon statutes and regulations that are uniformly applicable to all corporations subject to Iowa tax.

B. Iowa's Specific Adjustments To Federal Taxable Income Are Not Inconsistent With The Legitimate Purposes Of Federal Conformity.

Kraft points to nine adjustments in Iowa Code § 422.35 (1983) that it claims undermine the legitimate

purposes inherent in Iowa's federal taxable income conformity for the tax year 1981. (Kraft br. at 28) There is, however, no rigid rule that requires a state to adopt, without modification, the entire federal tax system or none of it.[11] "The most efficient and simplest method of achieving Federal conformity, without complete piggybacking, is to incorporate by reference in the State statute the current key Federal income tax terms, such as 'gross income' and 'taxable income' and then make such specific adjustments as State policy may dictate." Jerome R. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* ¶ 7.2[1], at 267 (1983). Iowa has adopted this approach. *Id.* at 267 n.19.

Under the logic of Kraft's reasoning, there can never be justification for coupling of state taxable income to federal taxable income to accomplish a legitimate state purpose if the state has enacted a few adjustments to the determination of federal taxable income. No authority supports this novel and unjustified position.

Neither the qualitative nor the quantitative nature of Iowa's nine adjustments require a Court to reject the overall coupling results (or any part of them) on the grounds that they somehow cause this coupling to no longer be rationally related to legitimate state purposes.[12]

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[11] Merely because Congress has elected a policy associated with income at the federal level does not mandate identical treatment by the States. *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 448 (1980).

[12] The first adjustment listed by Kraft is for interest and dividends from federal securities. Such income is generally

(Continued on following page)

Within the context of the Iowa law that provides for very few adjustments to federal taxable income in comparison to the vast array of coupling determinations and calculations, it is absurd to suggest that the Iowa tax system has only a remote relationship to federal taxable income.[13]

C. Iowa's Tax Treatment Of Dividends Is Not Subject To A Closer Look Under The Equal Protection Clause.

Avon attempts to alter the issue in this case by arguing that even if the Iowa tax system is valid under a traditional rational basis analysis, this Court should examine the system using a heightened scrutiny analysis because Kraft's claim is based upon alleged discrimination against foreign commerce and because corporations,

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(Continued from previous page)

taxed at the federal level. Iowa must constitutionally exempt such income from Iowa income tax in light of the doctrine of intergovernmental immunity. This doctrine cannot be overridden by an equal protection rational purpose analysis as "it is inappropriate to rely solely on the mode of analysis developed in our equal protection cases" when the issue is intergovernmental immunity. *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 816 (1989).

[13] While the nine adjustments are made to federal taxable income, most of them involve matters which are reported on the federal return and which are subject to audit by the Internal Revenue Service so that Iowa can take advantage of federal determinations to verify and enforce them. It is clear, therefore, that there is no merit to Kraft's claims that the Iowa taxable income concept is a "hodge-podge" and that the Iowa adjustments appreciably add to taxpayers' "time and money in tax preparation." (Kraft br. at 29)

like Kraft, cannot participate in the Iowa political process. (Avon br. at 19-23) Kraft makes no such claim below or here. An amicus cannot alter an issue as presented by the parties and, therefore, this Court should decline to address the equal protection claim under a heightened scrutiny standard.

Even if it is appropriate to consider whether a heightened scrutiny should be made, to do so would be contrary to precedent. This Court has applied a traditional rational basis analysis to evaluate equal protection challenges to taxes where a claim is made of discrimination based upon location or interstate commerce. *Amerada Hess Corp. v. Director, Division of Taxation*, 409 U.S. 66, 80 (1989); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869, 881 (1985); *Western and Southern Life Insurance Co. v. State Board of Equalization*, 451 U.S. 648, 668 (1981); *Madden v. Kentucky*, 309 U.S. 78, 87-88 (1940). There is no reason to depart from this well-settled mode of constitutional analysis. Avon relies upon dictum in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 n.3 (1973). (Avon br. at 19-20) In none of the tax cases cited by Avon was a "closer look," as advocated by Avon, made as opposed to a traditional rational basis analysis.

The Iowa Supreme Court noted that Iowa's dividend classification affected Iowa corporations as well as out-of-state corporations such as Kraft. (Pet. App. 7a-8a) Those Iowa corporations who receive dividends from foreign subsidiaries have access to the political process. Moreover, as Kraft showed, a number of states do exclude foreign subsidiary dividends from the income base, which suggests that there is taxpayer access to the political process. (Kraft br. at 8, n.10) Accordingly, Avon's

essential predicate, namely, that the Iowa political process is never amenable to the affected taxpayers is wrong.

D. Differences In Dividend Treatment Result From Differences In Business Structures Rather Than Location Of Commerce.

If Kraft had conducted its foreign business through a domestic subsidiary, dividends paid by that subsidiary would have been excluded from Kraft's apportionable net income. Kraft could also have created a domestic holding company subsidiary, with no Iowa connection, to own the stock of a foreign subsidiary and to receive the foreign subsidiary dividends. Thereafter, the holding company could pass such income to Kraft in the form of domestic dividends. Those dividends would be excluded from Kraft's apportionable net income in the same way as domestic subsidiary dividends paid from earnings accrued wholly in the United States. These results are consistent with the federal treatment of domestic dividends.

There can be no discrimination against interstate or foreign commerce if different tax treatment "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess Corp. v. Director, Division of Taxation*, 490 U.S. 66, 78 (1989). That is the situation here.

In *Regan v. Taxation With Representation*, 461 U.S. 540 (1983), in order to qualify to receive tax deductible contributions even while lobbying, an organization could set up a separate organization to do its lobbying. *Id.* at 544. The IRS required "only that the two groups be separately

incorporated and keep records adequate to show that tax-deductible contributions are not used to pay for lobbying." *Id.* at 544 n.6. That requirement was "not unduly burdensome." *Id.* Similarly, the actions which Kraft could take to avoid having its income attributable to its foreign operations included in its apportionable net income are not unduly burdensome.

III. IF IOWA CODE SECTION 422.35 IS HELD TO BE UNCONSTITUTIONAL, THE COURT SHOULD REMAND THE CASE FOR CONSIDERATION OF WHETHER THE HOLDING MUST BE RETROACTIVELY APPLIED AND WHETHER CORPORATIONS' CLAIMS FOR REFUND OF TAX ATTRIBUTABLE TO FOREIGN DIVIDENDS MUST BE GRANTED.

The Department raised as an issue in the lower courts whether a decision finding the Iowa corporate income tax facially unconstitutional can be applied to other taxpayers prospectively only and, if so, the scope of any such prospective ruling. (Pet. App. 23a, 26a, 51a) Evidence relevant to the prospectivity issue was included in the Stipulation. (Pet. App. 43a-50a) Because the courts below held that Iowa Code § 422.35 is constitutional, they did not address the question of refunds or the retroactivity of a holding of unconstitutionality.

In *James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439 (1991), Justice Souter stated that the remand of *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), for consideration of a defense raised by the state on the question of refunds "could be fairly read" as an implicit ruling by the Court that *Bacchus* applied retroactively. 111 S.Ct. at 2445.

Justice Souter also stated in *Beam* that "[b]ecause the *Bacchus* opinion did not reserve the question whether its holding should be applied to the parties before it, . . . it is properly understood to have followed the normal rule of retroactive application in civil cases." 111 S.Ct. at 2445. Therefore, the Department urges that, if the Iowa law is held to be unconstitutional, this Court expressly state that the Court is not ruling on the question of retroactivity but is expressly reserving the question for the Iowa courts to decide on remand.

The retroactivity question in this case is made more complicated by the fact that the Department, as a condition to receiving payment of taxes, agreed that in the event any of the issues in this case are decided in favor of Kraft, then Kraft and its former affiliate, Dart Industries, Inc. (Dart), would have full use, benefit and advantage of such decision with respect to calendar year 1975 and all years thereafter as to Kraft and with respect to calendar year 1971 and all years thereafter as to Dart. (Pet. App. 43a, Stip. ¶ 26; Exhs. A and B) The agreements were made prior to the decision in *Beam* which invalidated selective prospectivity. Therefore, the effect, if any, of *Beam* on whether the Department may deny refunds to corporate taxpayers will have to be determined. In addition, the Iowa Supreme Court should decide whether the agreement between the Department and Kraft is binding on that Court or whether that Court's inherent powers allow it to provide for prospectivity as to Kraft, Dart, and all other taxpayers. These determinations should be made in the first instance by the Iowa courts.

CONCLUSION

The Court should affirm the ruling of the Iowa Supreme Court. If the Court does not so affirm, it should expressly reserve the retroactivity question for the Iowa Supreme Court to decide on remand.

Respectfully submitted,

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APPENDIX

Relevant portions of 26 U.S.C. §§ 882(a), 991, and 995(a), as in effect in 1981, provided as follows:

§ 882. Tax on income of foreign corporations connected with United States business

(a) Imposition of tax

(1) In general

A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

(2) Determination of taxable income

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

§ 991. Taxation of a domestic international sales corporation

For purposes of the taxes imposed by this subtitle upon a DISC (as defined in section 992(a)), a DISC shall not be subject to the taxes imposed by this subtitle except for the tax imposed by chapter 5.

§ 995. Taxation of DISC income to shareholders

(a) General rule

A shareholder of a DISC or former DISC shall be subject to taxation on the earnings and profits of a DISC as provided in this chapter, but subject to the modifications of this subpart.

26 U.S.C. § 921(a) (1988) provides:

§ 921. Exempt foreign trade income excluded from gross income

(a) Exclusion. – Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.

26 U.S.C. § 245(c)(1) (1988) provides:

§ 245. Dividends received from certain foreign corporations

. . . .

(c) Certain dividends received from FSC. –

(1) In general. – In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to –

(A) 100 percent of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC, and

(B) 70 percent (80 percent in the case of dividends from a 20-percent owned corporation as defined in section 243(c)(2)) of any dividend received by such corporation from another corporation which is distributed out of earnings and profits attributable to qualified interest and carrying charges received or accrued by such other corporation while such other corporation was a FSC.

Iowa Code § 422.32(4) (1958)

Division III. Business Tax On Corporations

422.32 Definitions. For the purpose of this division and unless otherwise required by the context:

. . . .

4. The term "Internal Revenue Code of 1954" means Internal Revenue Code of 1954, as amended to and including December 31, 1956.

Iowa Code § 422.3(5) (1989)

422.3 Definitions controlling chapter.

For the purpose of this chapter and unless otherwise required by the context:

. . . .

5. "Internal Revenue Code" means the Internal Revenue Code of 1954, prior to the date of its redesignation as the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, or means the Internal Revenue Code of 1986 as amended to and including January 1, 1988, whichever is applicable.

Iowa Code § 422.32(6) and § 422.32(7) (1991)

6. "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

7. "Nonbusiness income" means all income other than business income.